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New FASB Interpretation 47 Requires Companies To Recognize Cleanup Costs Associated With Future Asset Retirement

Interpretation 47

One of the toughest accounting issues faced by a corporation is the proper estimation and tracking of its significant environmental remediation liabilities. In March 2005, the Financial Accounting Standards Board issued an interpretation of FASB Statement No. 143, "Accounting for Conditional Asset Retirement Obligations." The new "clarifying" interpretation likely will precipitate a major change to many companies' current accounting practices. In a nutshell, the new interpretation mandates that a company recognize the fair value of the liability it possesses for cleanup costs associated with future plant closure, such as the presence of asbestos in a building or factory. The interpretation extends beyond plant closure, however, and attaches to any asset retirement activity - even if that activity can be deferred indefinitely - so long as an existing law, regulation or contract requires an entity to perform the activity upon retirement of the asset. In other words, the obligations associated with retirement are not conditional, but instead, only the timing or method of settlement are conditional on a future event that may or may not be within the control of the entity. Retirement encompasses sale, abandonment, recycling, or disposal in some manner.

For example, a telecommunications entity whose communication network uses wood poles treated with certain chemicals has certain legal obligations regarding the disposal of the poles once removed from the ground. Although the company is under no legal obligation to remove the poles, it has sufficient experience to determine its replacement frequency, or in the words of the Interpretation, "the entity has information to estimate a range of potential settlement dates, the potential methods of settlement, and the probabilities associated with the potential settlement dates and methods... [and] is able to estimate the fair value of the liability for the required disposal procedures using an expected present value technique."

The Interpretation acknowledges that in some cases sufficient information about the timing and (or) method of settlement may not be available to reasonably estimate fair value. For example, if currently "there is an indeterminate settlement date for the asset retirement obligation because the range of time over which the entity may settle the obligation is unknown or cannot be estimated," the entity cannot reasonably estimate the fair value of the liability. In such instance, the Interpretation states that the entity should disclose the obligation, state that the liability has not been recognized because fair value cannot be reasonably estimated, and explain why it cannot be reasonably estimated. The company would then recognize the liability in the future period when sufficient information is available. One example provided by the Interpretation pertains to asbestos containing materials within a building where the company has no present intention to either sell or renovate the building.

FASB believes that Interpretation 47 will result in (a) more consistent recognition of liabilities relating to asset retirement obligations, (b) more information about expected future cash outflows associated with those obligations, and (c) more information about investments in long-lived assets because additional asset retirement costs will be recognized as part of the carrying amounts of the assets.

Interpretation 47 is effective no later than the end of fiscal years ending after Dec. 15, 2005, or Dec. 31, 2005, for calendar-year enterprises. Retrospective application of interim financial information is permitted but is not required.

Analysis

Use of an interdisciplinary team, melding legal, environmental, engineering, and accounting talent, will increase the effectiveness of a company's evaluation of its financial reporting obligations under FASB 143. Companies need to evaluate their facilities and other assets and determine, initially, whether an existing law, regulation, or contract

requires an entity to perform an activity upon sale, abandonment, recycling, or disposal. Many companies have not considered what legal obligations attach to asset retirement while others likely have not adequately performed this analysis. Future “closure obligations” typically are not included in environmental audits, either those performed in connection with the purchase of an asset, or those periodic “operational audits” performed to measure and maintain environmental and OSHA compliance.

Once the legal obligations attaching to retirement of an asset are properly identified, the company’s FASB 143 analysis will shift to whether the entity has sufficient information to reasonably estimate the fair value of the asset retirement obligation. Uncertainty about the timing and (or) method of settlement of a conditional asset retirement obligation will need to be factored into the measurement of the liability. The practical effect is that a company will need to obtain a better estimate of the closure costs it is likely to face, and then price those obligations using present value techniques or other methods of valuation such as when an active market exists for the transfer of the obligation. Even where the liability cannot be reasonably estimated, the company will need a mechanism that tracks the liability over time and the company’s future plans as they might affect that asset, so that the liability can be recognized when sufficient information becomes available.

A copy of the Interpretation is available at:
<http://www.fasb.org/pdf/fin%2047.pdf>.

Questions regarding the Interpretation and its implications should be directed to an attorney in the Environmental, Safety and Toxic Tort Practice Group, or the Seyfarth Shaw LLP attorney with whom you normally work.

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